# DOW THEORY LETTERS INC.

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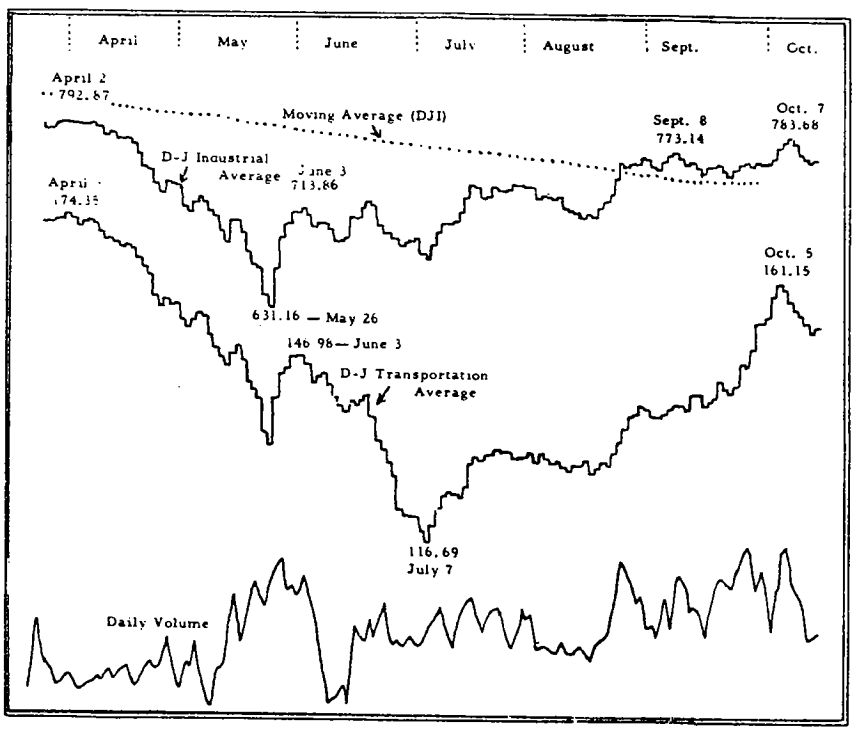
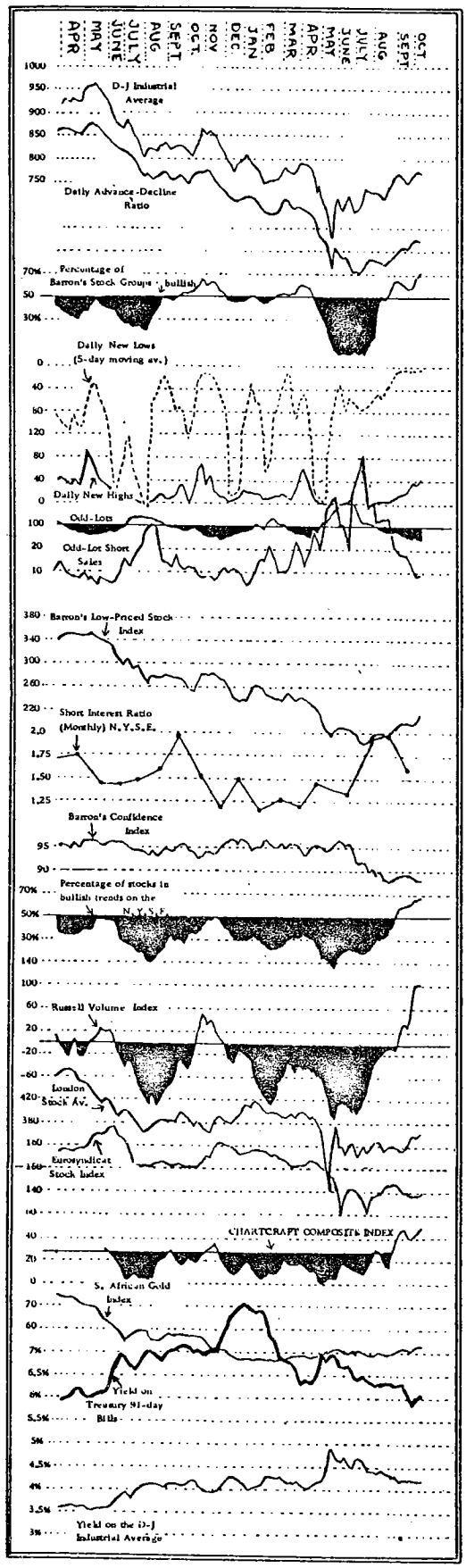
THE MARKET: From all quarters, amateur "Dow Theory Experts" have announced that the September 28 action of the Transportation Average (in bettering its June 3 peak of 146.98) has signalled a "new bull market". I have tried to explain that such an interpretation of the Dow Theory is nonsense. Nothing is right today for the birth of a new bull market. The stock market fundamentals and technical considerations which are classically present at or near the termination of a bear market are absent today with a vengeance.

Psychology is wrong, yields on common stocks are wrong, yields on bonds are wrong, market volume is wrong, speculative sentiment is wrong. Those who are pinning all their hopes on a mechanical configuration in the D-J Averages, I fear, are also going to be proved wrong. Since June 3, which was the date of the initial rally from the May 26, 1970, lows, more than a quarter of a billion shares have changed hands on the N.Y.S.E. Since that time Industrials have plowed upwards with Transports failing to confirm. Finally, on September 28, Transports did confirm, but on the same day Industrials (which were below their September 8 peak of 773.14) actually declined. After a spate of huge-volume churning, the two Averages pushed up and on October 5 Industrials stood at 776.70, Transports at 161.15. That single day of October 5 was the first day since June 3 that the two Averages were able to establish joint recovery highs. In other words, there has been only one day since June 3 in which both Averages were able to poke their heads into new recovery high ground together.

The following day, October 6, saw Industrials continue their rally while Transports declined. The Industrials rally lasted one more session, to





D-J Industrial Average
Daily Advance-Decline Ratio
Percentage of Barron's Stock Groups bullish
Daily New Lows (5-day moving av.)
Daily New Highs
Odd-Lots
Odd-Lot Short Sales
Barron's Low-Priced Stock Index
Short Interest Ratio (Monthly) N.Y.S.E.
Barron's Confidence Index
Percentage of stocks in bullish trends on the N.Y.S.E.
Russell Volume Index
London Stock Av.
Eurosyndicat Stock Index
CHARTCRAFT COMPOSITE INDEX
S. African Gold Index
Yield on Treasury 91-day Bills
Yield on the D-J Industrial Average

 October 7, a day which saw Industrials at a new recovery high of 783.68 (and Transports off 2.43). From that point on both Averages declined, and I felt that in all, the market performance was poor in that strength evaporated after the joint recovery high day of October 5. Often, it is what the market does not do which tells us more than anything else. The fact that the first joint recovery highs (Oct. 5) in four months could not elicit any follow-through strength smacks to me of distribution of the most flagrant kind.

From another side, the picture appears to be deteriorating. The D-J Utility Average, which often provides good lead characteristics, has now traced out a downward zig-zag. From its August peak the Utility Average declined to a September 21 low of 107.41. A mild rally carried into late-September, following which the Utilities declined again. On October 6 the Utility Average sank below its September 21 low, thereby declining to its lowest level since mid-August. Thus the Utility Average is the first of the three D-J Averages (since the entire upward movement began) to give a bearish indication in its actual price structure.

And from yet another sector the "bullish thesis" seems to be running into trouble. On Monday (October 12) the price of gold in London rose above $37 for the first time this year. The spurt in gold saw Campbell Red Lake at a new high for the year (above 29), and Dome mines at 62, within a fraction of a new high. Meanwhile, the dollar was selling at a 6% discount on the Swiss markets, as millions of unwanted dollars continue to pile up in foreign central banks. From everything I read, it is obvious that Europeans are becoming increasingly reluctant to play along with the U.S.'s game of "inflation and export the deficit". The thin veneer of U.S.-European monetary relations is straining to the breaking point, and one wonders what day, week or month will see Europeans turning in massive amounts of dollars for U.S. gold.

But the stock-buying public, still bathed in its euphoria of the past few months, is hardly ready to believe that the writing is on the wall for this latest rally or upward correction. Watching the waves instead of the tide, they have again loaded up with common stocks during this primary bear market. To my mind it will only be a matter of time before these new bear market entrants will be wiped out as were their predecessors during the collapse of 1969-70. As for my readers, I can only say that I hope that you are all exercising patience as we wait for the great primary bear trend to fully express and finally exhaust itself (probably some time in 1971 or '72). At that time, we will have an opportunity to purchase top-grade investment and growth stocks at rare bargain prices, as we wait for the inception of the true primary bull market which is sure to follow.

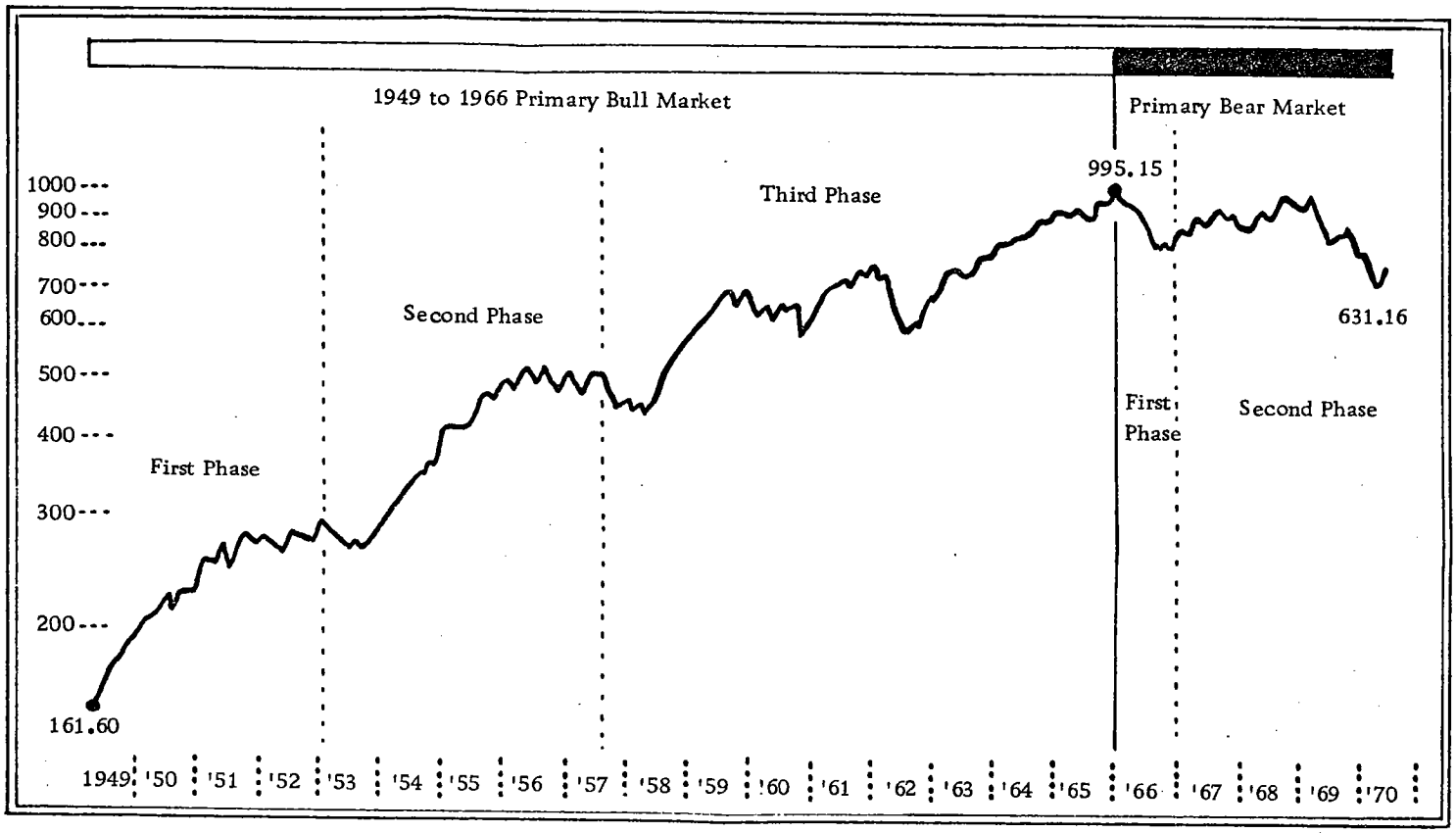
WHERE ARE WE: Every time a significant rally occurs in a major bear market, it is characteristic of investors to get emotionally caught-up in the short to intermediate term trend. Those who continually "play" the short term in a bear market will almost always lose their money. Those who play the intermediate term will probably lose their money over any reasonable period of time, because for every profitable rally there are three or four short-lived, disappointing spurts (commonly known among traders as "whipsaws"). Those who invest fully in primary bull markets and stay out of primary bear markets are acting in harmony with the strongest force on Wall Street. They are the ones who are most likely to make a good deal of money on the bull side and remain relatively unscathed on the bear side.

In order to help my subscribers understand where we are and what it is all about, I include periodic long-term charts of the big picture. The accompanying chart (page 3) is a new one which I just drew up showing the giant bull market of 1949 to 1966 and the bear market of 1966 to date. From a structural standpoint, the 1949-66 primary bull market was remarkable in that its three (psychological) phases were very unorthodox in duration. "Normally," the first and third phase of a bull market are the shorter phases, while the second phase is the longest.

Note, however, that the first phase of the bull market was the shortest phase, the second phase was slightly longer (1953 to 1957) and the third or speculative phase was by far the longest (1958 to 1966). The reason why the third phase of the 1949-66 bull market was so long is that the Government stepped in repeatedly with every conceivable kind of manipulation. The manipulations, of course, were all attempts to keep the boom going.

The continued Government interference finally had the effect of putting the nation's economy on a very shaky sheet of ice. Instead of correcting the excesses, U.S. industry continued to grind away, and emphasis (under young managers) was placed increasingly on production and sales, while the fiscal side of the ledger was largely ignored. Corporate liquidity sank to record levels, debt rose to record levels, prices and wages surged rampantly higher, and in February, 1966, the great primary bull market ended.

The first phase of the bear market was rapid and rather drastic, taking the Dow from 995.15 to 744.32 in a period of eight months (February to October, 1966). From there (spurred by gigantic infusions of Government-led inflation) the Dow pushed up in a massive upward correction to 985.21 in December, 1968. Following the upward correction, the




Dow headed down, and by May, 1970 it had dropped to 631.16, a loss of 364 points from the 1966 high.

Unfortunately, the second phase of the bear market (so far) has done little to correct the unbelievable excesses of the 1949-66 bull market. Volume is still high, speculation is still rampant, stock yields are low and bond yields are high, corporations are more illiquid than ever and inflation is as strong as ever.

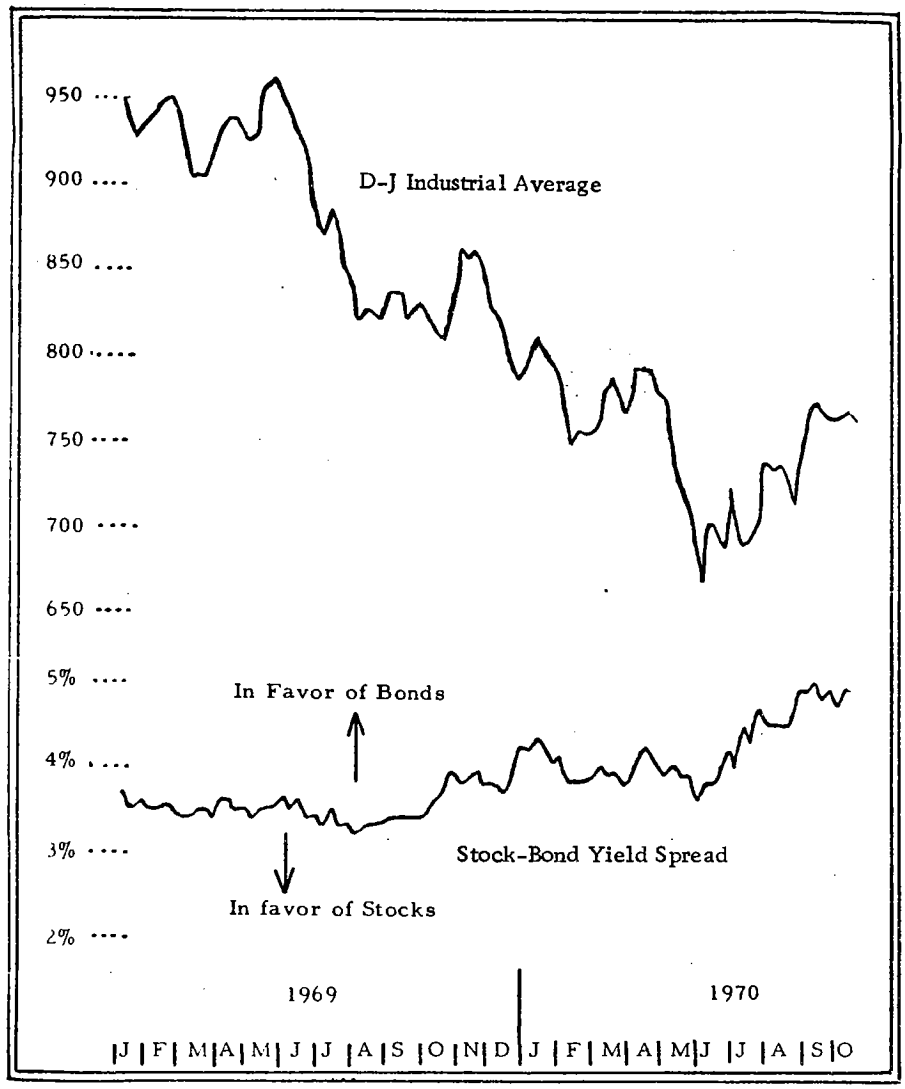
I believe that this bear market is going to be a long and drastic one. One of the reasons for my belief is simply that there is still so much to correct. The unbelievable nine-year third phase of the preceding bull market has put the nation on a tenuous footing, and all of those excesses will need to be wiped out. To make matters worse, additional excesses have been built into the nation during the five years of the bear market. The longer the bear market goes without bringing on major corrective factors, the more drastic will be the final conclusion. I would guess that the real trouble will enter during 1971 and 1972. And in the meantime, I would advise subscribers to forget about the rallies, big or small, that will serve to "suck in" the perpetual optimists, the amateurs, the unwary and the ignorant. The big picture is the important one. I have tried to present it in the foregoing paragraphs.

WHAT CORRECTION? The accompanying chart (page 4) is quite fascinating in its implications. The chart traces the spread between the yield on the D-J Industrial Average and the yield on the broad D-J 40-Bond Average. The period covered is January, 1969, to the present, which is roughly the period of the last shattering bear market decline and the rally from the May 26, 1970 lows.

The incredible fact is that as things now stand, the inverse (negative) yield spread in favor of bonds is the worst it has ever been. For instance, whereas the negative yield spread in favor of bonds was in the 3.5% area during late-1968 and early-1969 (when the big decline began), it was actually 3.6% at the May 26, 1970, low.

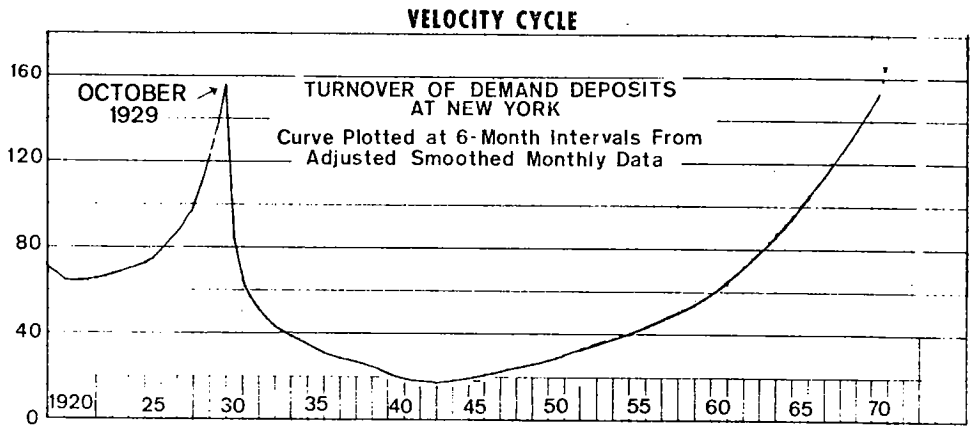
Since then the negative yield spread has risen to a record 5% during the week ending September 7 (with the Dow at 770 area). In other words, as this bear market approaches its fifth year, the extremely fundamental stock-bond yield spread is further out-of-whack than ever before. Nothing has been corrected!

Primary bear markets exist for the purpose of correcting economic ills. I am therefore increasingly afraid that before this bear market is over, a great deal more drastic downside action will have to take place. Downside action in the stock market will push up stock yields, thereby satisfying one side of the stock-bond yield equation. And the resultant scramble for liquidity brought on by a market smash and an economic recession will ultimately ease up the pressure in the money markets, allowing bonds to rally and in all probability setting off the first major bull market in bonds since 1946 (when the last bull market in bonds ended).




Let's look at it another way. Nothing lasts forever in the markets. The negative yield spread between stocks and bonds has now existed for 12 years. The bear market in bonds has been in effect since 1946, a period of 24 years. That bear market should expire soon; The bear market in stocks has been in existence almost five years. The bear market in stocks should be going into "high gear" shortly. All of these factors should be coming together soon to produce a positive yield spread between stocks and bonds. The final wind-up is drawing ever-closer.

MONETARY FRENZY: The accompanying chart is from the current issue of the Bank Credit Analyst edited by Mr. Donald Storey. The chart presents a remarkable phenomenon in the history of American finance. Here we see the turnover of demand deposits (checking accounts) in New York, which is the nation's leading financial center. The latest figures show that turnover increased in September to 162, which, for the first time surpasses the 156 of 1929.




Any curve of the kind pictured here must ultimately rise to a "point of no return". This is what occurred in 1929, and when the speculative cycle was punctured, the turnover dropped from 156 times a year (actually better than three times per week) to below 40 during the early 1940's.

What this chart means to me is that money is doing more and more work to keep this economy going at its present level. Mr. Storey takes the new high in demand deposit velocity to mean that the super-cyclical forces are still at work. He feels that the velocity curve may even climb higher, and he further states that "This will involve eventually higher interest rates and lower levels of bank and corporate liquidity and hence growing instability and vulnerability in the financial structure."

My main point in showing the chart is to demonstrate, as I have often tried to do, that nothing has been corrected by the bear market so far. In this same Letter I show that the bond-stock yield spread is at its most negative position in history. Add to that the velocity of demand deposit turnover in New York is at its most frenzied state in history.

The primary bear market has dampened but certainly not killed speculation on the stock exchanges. The bear market has not even begun to effect business transactions in New York where for various reasons demand deposits are doing more work (i.e., turning over faster) than ever before. Before this bear market is over I expect a widespread collapse in all markets which will smash speculation both in the security markets and in the economy. At that time, Mr. Storey's velocity curve will top out and head to far lower depths. That collapse should correspond with a general cave-in in confidence both in stocks and in the economy. Judging from my charts and statistics, we are no where near that point yet.

SOME QUESTIONS AND ATTEMPTED ANSWERS: For over a decade I was in the position of defending the confirmation principle of the Dow Theory. From one side I was besieged by those who claimed that the many new averages were superior to the DJI in that they more accurately reflected the movements of the industrial segment of the market. To this, I agreed, but again I will state that the DJI is a leading market indicator, and that it is indeed far from an accurate "average" of the industrial segment of the market. The DJI should be accepted for exactly what it is, an average of thirty leading giant corporations. As an indicator to be used in confirming (or failing to confirm) other indicators such as the advance-decline ratio, the Transportation Average, the high-low index, other averages, I feel it is excellent.

Ever since 1958 when I began writing this service I have had to defend the D-J Rail average as a legitimate indicator of transportation and shipping. I was told that the rails were an atrophying industry, and that only the inclusion of airlines and trucking would make the Rail index worth anything. I was never fully convinced, but I am nevertheless happy that Dow Jones & Co. finally "modernized" the Transportation Average by including trucking and airline stocks.

Despite all, however, it is worth noting that the Rail Average hit a record high of 279.88 on February 7, 1969. If the Rails were dying, their Average did not show it at the time. In fact, the Dow Industrials failed to confirm that record Rail high. Those that followed the Dow Theory were sufficiently warned by the flagrant lack of confirmation on the part of the DJI. Those who applied other averages to the Dow Theory in 1969 saw many of those other averages go to new highs and thereby received a signal that everything was all right. Everything was not all right, and following the non-confirmation on the part of the old DJI, the market went into its worst collapse since the late-1930's.

Now my latest problem is that I am receiving letters stating that the Transport Average is too volatile, rendered so by the inclusion of the airline issues. I disagree. All that is wanted in an average, as far as confirming ability is concerned, is that it relates to its previous peak or low. For instance, (and this is theoretical) if the Transports record a price of 150 in October, then decline, I am only interested in whether they better 150 on the next rally. Volatility has nothing to do with it. I don't care about volatility or whether the swings on the new Transportation Average are greater in percentages than they would have been on the old Rail Average, I am still interested only in the ability (or inability) of the Average to better preceding peaks or low points.

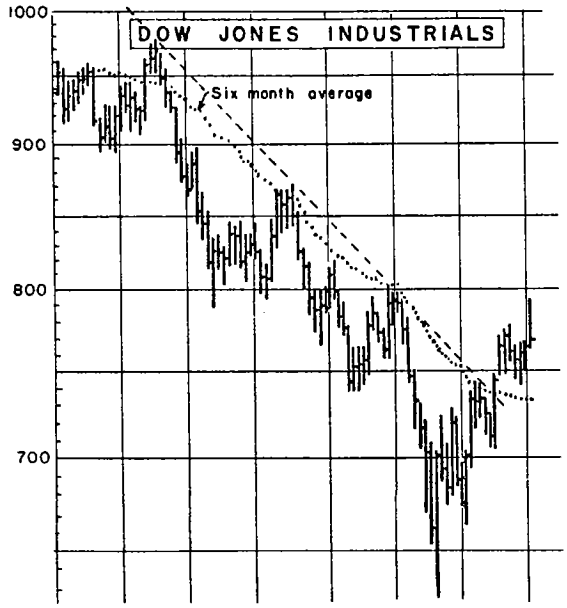
Finally, I want to repeat again that in general, subscribers pay far too much attention to mechanical problems and whether the Averages confirm — and far too little attention to where we are in the big picture, whether the market has gone through its phases, whether stocks represent values, etc. Right now, as a matter of fact, I am fully as interested in the stock-bond yield relationship as I am in whether both Averages are capable of setting new recovery highs. Those who place all their attention on the mechanics of the Averages are almost sure to be wrong at the major turns. Furthermore, with the confirmation thesis now so widely followed from Coast to Coast, I would almost prefer to downgrade the matter of confirmation at the moment.

VOLUME: In Letter 473 I mentioned Mr. Paul Dysart's discovery (he founded the famous Trendway Service of Louisville, Ky.) that the emotional public tends to make its moves on increasing Exchange volume, and the unemotional investment sector tends to make its moves on decreasing volume. The Trendway Service, in fact, keeps an index of "negative volume" which indicates the plurality of advances over declines (or vice-versa) on days when volume drops below volume of the preceding day. Lately, this index has been bearishly collapsing, showing that on a trend basis the informed minority has been selling continuously even while the emotional public has been buying.

Merrill Analysis (Box 228, Chappaqua, N.Y. 10514) keeps an "Enthusiasm Index" which I read in the same way (page 6). This is a ratio of volume on the last five rising days as against volume on the last five declining days. If you study this

chart (the Dow is superimposed) you will perhaps be surprised to note that "enthusiam:" (as evidenced by increasing volume on rallying days) has been a persistent characteristic of the entire 1969-70 collapse. And during the rally since the May, 1970, lows, enthusiasm has mounted to massive heights.

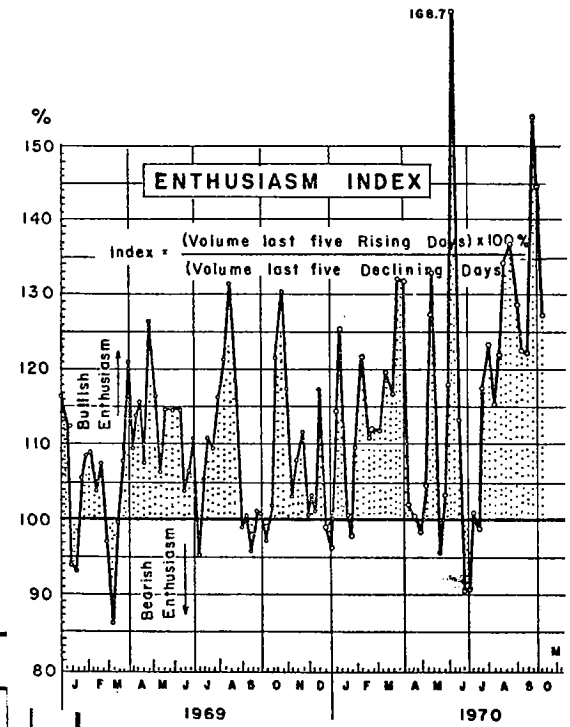
I infer from this chart that so far in this bear market there has been no real eagerness to sell from the public. They have been eager only to buy, as seen in this fascinating volume study. My guess is that before the bear market is over, the crowd actually will turn bearish. At that time the enthusiasm index will show volume expanding on declining days, and Mr. Merrill's chart will look quite the opposite in that volume on declining days will fill the chart as the market goes down. As a final comment, I will add that to my knowledge, no major bear market in history ever ended without some period of "bearish enthusiasm" being generated by the public.

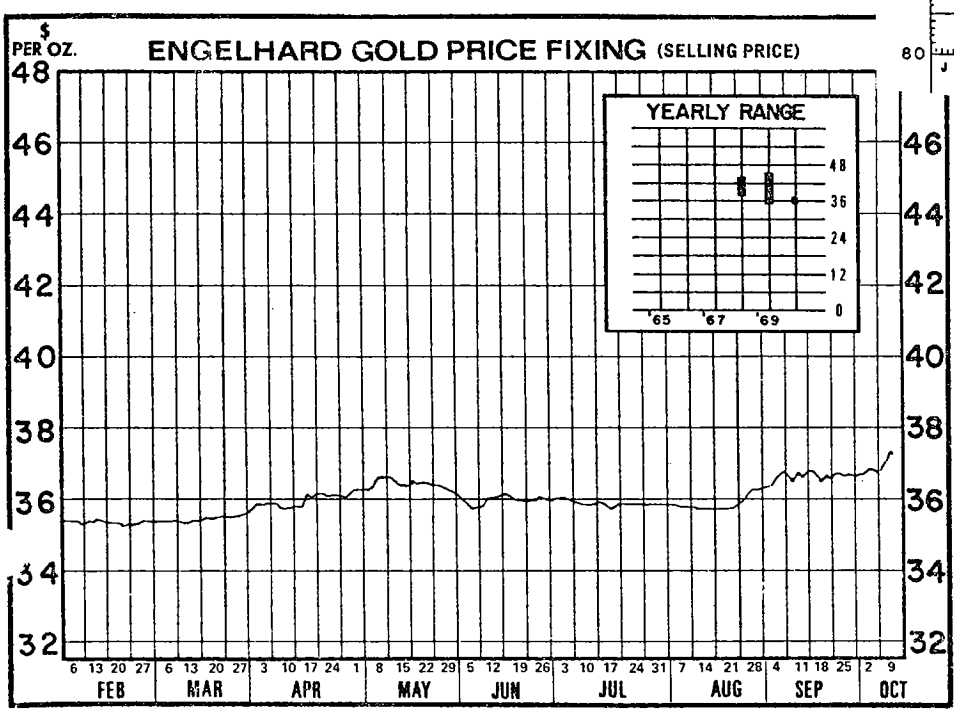



GOLD: Gold reminds me of a sprint champion at an all-day track meet. You'll see him laying around, flexing now and then, but mostly just sitting there apparently detached from all that is going on. Then the 100 yard dashes start, and the champion becomes all tension and explosive energy. Finally, the race and in that 9 to 10 seconds the champion makes up for a whole day of inactivity.

Gold has been subject to one of the biggest barrages of official denunciations during 1969 and 1970 that I have ever seen. Everything was going to put gold "out of style," and the yellow metal was supposed to be a relic in our time. As seen on the chart (courtesy of Kaffir Chart Service, Palisades Park, N.J. 07650), gold lolled around all during 1970, starting the year at just over $35 per ounce and ending up in August at just under $36 per ounce, a gain of only a dollar in seven months.

Then gold started moving into a mild sprint. By mid-September it was just under $37 per ounce and by mid-October it was $37.42 per ounce. What is unusual about the move is that speculative activity in gold usually begins before an I.M.F. meeting. This time, following the I.M.F. meeting gold started to sprint, and with it new highs in the gold shares started dotting the Board. What's going on? Why is a potential gold move underway? My own guess is that with a $12 to $20 billion U.S. deficit




coming up, the foreign central banks are getting restless. When the chips are down the U.S. has always gone for more inflation, rather than unemployment and recession. And meanwhile, as the dollars pile up in Europe the nerves of the central bankers are getting increasingly frayed. The drama of Administration dreams vs. the hard reality of gold is on again.